

The World Economy: Sharpening Our Peripheral Vision

*Remarks before the Council of Economic Advisors to
Utah Governor Jon Huntsman Jr.*



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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Governor Huntsman and I have a great deal in common. We both married smart women. We are each blessed with many children. And we both had the privilege of serving as deputy U.S. trade representatives. The governor was on the board of the San Francisco Federal Reserve Bank's Salt Lake City branch. Thus we share membership in the Fed family. Another common experience is that we have both run for public office—Jon doing so successfully and me doing so miserably.

I ran for the United States Senate in Texas a decade ago, but my labors in the vineyards of politics yielded little more than prune juice. I am glad Jon's political experience has been more satisfying, and I am delighted to see him thriving as the leader of the Beehive State.

Let me state at the outset that the views I express today are entirely my own, buttressed by the research of the Dallas Fed's staff of economists. I am indeed a member of the Federal Open Market Committee—the FOMC—and I vote this year on monetary policy. But only one person can speak for the committee and the Federal Reserve as a whole, and that person is Chairman Greenspan.

Just last week, the chairman served as the official voice of the Federal Reserve in giving the semiannual outlook before both houses of Congress. No doubt you are familiar with his testimony. So I thought we could better use our time this morning to talk about an increasingly important facet of the economic context in which the FOMC seeks to encourage sustainable, noninflationary growth. That is the way we are interconnected with the rest of the world, a world Governor Huntsman and I—along with all who preceded and succeeded us as trade negotiators—labored, at the behest of our presidents, to make more open to commerce.

The work of trade representatives is inspired by the innate instinct of Americans to compete. For the people of Utah, of course, this is second nature. The legacy of your pioneer heritage, like that of Texans, is rugged individualism, an entrepreneurial spirit and a can-do culture. It is with this mindset that we partner with the 48 other states in the most dynamic, productive enterprise of all time—the American economy.

This American economy is a mighty machine. Its sheer size and vigor were evident in the first-quarter GDP numbers. They show that we have a \$12 trillion-plus economy, growing at 3.8 percent a year after taking inflation into account. Do the math: 3.8 percent of \$12 trillion comes to about \$460 billion a year in incremental economic activity.

This is a big number. What we add in new economic activity in a given year exceeds the entire annual output of all but 15 other countries. Every year, we create the equivalent of Sweden's economy ... or more than two Irelands or three Argentinas. In dollar terms, our current growth rate of 3.8 percent is equivalent to a 17 percent surge in Germany's \$2.7 trillion economy, a 28 percent leap in China's \$1.6 trillion GDP or 67 percent in India's \$690 billion national output.

The dominance of the American economy takes on special meaning for an old trade negotiator. The United States imported \$1.8 trillion in goods and services in 2004. What we bought abroad exceeded the entire GDP of Italy or China. Indeed, only four other countries produced more than we imported.

I stress this for two reasons. First, I want to put into perspective our economy and the perceived threat of new competitors. I was the quarterback of my high school football team. Playing the position taught me the value of many things, not the least of which was the need for peripheral vision—an ability to see what’s happening all over the field to avoid being sacked by the competition. Tunnel vision leaves you vulnerable. When it comes to the world economy, we as Americans need to sharpen our peripheral vision. The more we know about the world, the better we can compete within it.

Second, I want to emphasize the importance of keeping our house in order—for like it or not, the world’s prosperity depends on the U.S. economy. The global economy cannot perform adequately unless we perform superbly. And that is what we are doing, despite what you may have been hearing from the naysayers and doom and gloomers. Over the past several years, we have managed to grow in the 3 to 4 percent range, while maintaining core inflation of 1 to 2 percent. It would not be immodest for Americans to say the U.S. economy shines brightly.

We could no doubt list a dozen or so reasons the U.S. economy is doing so well. I will mention just two of them, both dear to the heart of a trade negotiator turned central banker. First, as I mentioned earlier, there is our willingness and ability to compete in the global marketplace, rather than erect barriers to competition. Second, there is the blessing of having a central bank—the Federal Reserve—that is independent and free to conduct policy with a steady hand.

To be sure, there are potential economic imbalances that could dim our luster. Some are predominately domestic phenomena—such as fiscal deficits, the problems of financing our health care and Social Security systems, and the unsettling price increases we are seeing in certain housing markets. Others, like our current account deficit, stem from a confluence of internal and external forces—a high propensity to consume and a disinclination to save on our part, combined with the inability of some former engines of global growth, such as Germany and Japan, to generate domestic consumption rather than depend on exports.

But the bottom line is that America is the main driver for global economic growth. At the same time, there is a perceived threat to our prominence from new quarters, specifically India and China. The concern *du jour* is China, so let us focus there for a moment.

I was part of the team that negotiated China’s entry into the World Trade Organization, helping bring the world’s most populous country into the global economy in 2001. More than two decades earlier, I had been lucky to witness firsthand the initial stirrings of the Chinese economic revolution.

In 1979, I was a young member of the U.S. delegation President Carter sent to China to settle the claims left after Mao’s government seized the railroad rolling stock we had lent Chiang Kai-shek. President Nixon had normalized political relations in the early 1970s, but it fell to President Carter to normalize economic relations and finally raise the flag at the U.S. Embassy.

So we could begin to trade with each other and get on with a normal relationship, Treasury Secretary Mike Blumenthal was sent to negotiate with Deng Xiaoping. I was Blumenthal's assistant, so I accompanied him to all his meetings with the Chinese leader. I will never forget our first meeting with Deng. He was electrifying. You may remember he was a short fellow—well under 5 feet, if memory serves. But he was a giant of a man with big dreams. In our first meeting, he entered the room and cackled, “Where are these big American capitalists I am supposed to be so afraid of?”

He then laid out his vision of driving China down “the capitalist road,” a plan he did not proclaim publicly until years later. Deng told us then that he would unleash the Chinese genius and focus it on development and modernization. To him, when it came to ideologies, it didn't “matter whether the cat is black or white, as long as it catches mice.”

And mice they have caught in droves. Since 1979, China has grown at better than 9.4 percent a year, adding up to a tenfold expansion of the economy. China's factories produced 200 room air-conditioners in 1978; today, they make 70 million a year. Back in the dark old days of rigid central planning, the Chinese produced 679,000 tons of plastics; last year, they were up to 18 million tons—26 times as much. In 2003, China turned out 260 billion more square feet of cloth than it did in 1978. Today's great building boom is occurring in China, where 28 billion square feet of floor space is under construction for all kinds of buildings, compared with 5 billion in the United States. By 2010, China may well boast seven of the world's 10 largest shopping malls.

Americans have been a big part of China's growth. The country's exports to the United States have nearly tripled since we inked our bilateral World Trade Organization deal in 1999 and risen by 1,100 percent over the past 15 years. In 2004, the total rose to \$197 billion, making China second only to Canada as a supplier to our markets.

All those billions boggle the mind. I spent last weekend playing golf with my son in California, so let me use golf clubs and balls as an example of China's growing export prowess. Fifteen years ago, the country was barely a blip in this market. Now, the Chinese are selling us 13.5 million golf clubs a year, or 92 percent of our club imports. They shipped us 53.7 million golf balls in 2004, or half our ball imports. The average wholesale cost of a Chinese golf ball: 25 cents. That is nearly half the price of those from other countries, which is a good deal for a high handicapper like me. It keeps my costs down and lessens the sting of losing a few dollars to my son on every round.

I could recite endless eye-popping statistics on China's economic progress over the past quarter century. But you know the story—an economic colossus is rising on the far side of the Pacific. And this is making some Americans nervous in much the same way petrodollar-rich OPEC did in the 1970s and Japan did in the 1980s. On any given day, our newspapers and airwaves crackle with talk about China's role in ballooning trade deficits, spiking commodity prices and lost manufacturing jobs. The Chinese bid for Unocal and the revaluation of the Chinese currency have dominated news reports in recent days.

When it comes to China, however, it is important that we think beyond the headlines—beyond the hype—and keep things in perspective. China is indeed steamrolling its way down the capitalist road. But when we use peripheral instead of tunnel vision, we see that China remains far behind the United States in the requisites of a world-beating economy.

To begin with, while China's workers are cheap to employ, our workers are far more productive—by a factor of five in industry and 29 in agriculture. We have everything a modern economy needs to operate efficiently, whereas China's infrastructure is improving but still wanting. We have 19,497 airports; China, just 126. We have 150,000 miles of petroleum pipelines; China has less than 10,000. China has only one-fourth the U.S. road system. When it comes to power plants, dams, satellites, Internet servers, fiber-optic cable and other basic assets, the Chinese have just a fraction of what we have.

Nor can China match our cadre of managers. This is an area economists have trouble quantifying, but keen observers of the U.S. economy sense the huge qualitative advantage we derive from having millions of experienced, savvy decision-makers, their skills honed by decades in the crucible of capitalism. Our managers are experienced. They are wonderfully creative and adaptive. The best of them have an instinctive feel for navigating the treacherous waters of a changing world economy. The Chinese are smart, but they have been on the capitalist road for a relatively short while. Developing the managerial talent pool required to make independent decisions and compete in a global economy takes time.

Capitalism isn't just about physical assets and managerial acumen. A market economy cannot function effectively without a willingness to eliminate protectionism, reduce red tape, encourage open markets for capital, live by the rule of law, punish public corruption, police corporate malfeasance, and let old jobs go by the wayside.

China has improved somewhat in these dimensions, but it is still far behind the United States and other world leaders in every single one. For example, they rank 31st in the International Institute for Management Development's 2005 competitiveness score. They rank 112th in the Heritage Foundation's economic freedom score. They rank 71st on Transparency International's 2004 corruption score. The ideas, designs and processes that fuel economic advancement are protected by the rule of law in the United States. In China, they are too often purloined.

The cutting edge of the world economy lies not only in protecting the rights to knowledge but in having a system that encourages accumulating more of it. The Chinese are a long way from a superb educational system. Just 15 percent of China's population aged 25–65 has a high school degree, compared with 84 percent in the United States. One of every 20 Chinese in that age group has a college degree, compared with almost 1 in 3 in the U.S. China has 86 university students per 10,000 people. We have 562—about seven times as many.

In spending so much time on China, I hope to deflate the alarmist rhetoric about threats to our economy. Remember that Japan grew much faster than we did for three decades after World War II but slowed as it converged to U.S. levels of per capita GDP. The same goes for Germany. And Korea. And Taiwan. There is a good reason economies converge as wealth increases: It is easier to run down a path already cut by the leader than to hack your way through virgin jungle.

China's emergence will trigger changes to our economy, but they will not come so fast or be so big as to overwhelm us. We will have time to adjust. We have proven time and again that we thrive when we face up to the challenge of vigorous competition. It was this demonstrated ability to reap gains from competition that led us to pursue trade liberalization hammer and tongs and why we sought to bring China into the World Trade Organization.

Long ago, the case for competition was articulated by such economists as David Ricardo and Adam Smith—and by enlightened political leaders as well. Among free-trading politicians, one of my favorites is Grover Cleveland. We don't hear too much about Cleveland anymore, but I suspect he's not forgotten in this part of the country. After all, he was the president who signed the proclamation making Utah the 45th state on January 4, 1896, ending a half-century struggle.

Cleveland understood the magic of tearing down American barriers to competition from all comers. In his third address to Congress, he characterized tariffs as “a vicious, inequitable, and illogical source of unnecessary taxation ... which imposes a burden upon those who consume domestic products as well as those who consume imported articles, and thus creates a tax upon all the people.”

To be sure, Cleveland knew full well that foreign competition harms some industries and certain workers. He also understood the greater truth—that imports untaxed by tariff and nontariff barriers are not poison for the overall economy. They are a tonic, an incentive. Bargains from abroad lower the cost of living. When consumers pay less for clothes, shoes and electronics, they have money to spend elsewhere, to the benefit of domestic businesses.

What Cleveland told us 100 years ago applies today. Cheaper inputs help American producers lower their costs. Just as important, foreign competition forces U.S. producers to cut costs and bolster efficiency, providing a spur to productivity and managerial innovation. We thus climb up the technology ladder to the bio- and nano- and other cutting-edge industries. These emerging high-value-added sectors will keep us at the forefront of the global economy and allow business to do what it does in a capitalist system—create jobs and make profits that in turn lead to more jobs and profits. The proper role of a healthy economy is to destroy the jobs others can perform more cheaply ... and replace those jobs with new and better ones.

How can economies do this? Many factors play a role but two stand out—an economy open to competition and a well-educated, adaptable workforce.

The leading economies force themselves to stay open, knowing they will sharpen their wits and tone their muscles by facing the competitive forces that foment economic change.

The leading economies push themselves ahead on the educational curve and continually re-educate their workforces to stay at the forefront of the value-added race. Globalization and challenges from new economic players will overwhelm nations whose schools aren't up to snuff.

The highlight of the Dallas Fed's current annual report is an essay on the economic value of education. I commend it to you. It shows clearly that schooling pays off for individuals. For a young worker, for example, getting a bachelor's degree means average earnings of \$30,000 a year more than what the least educated worker makes. Over a lifetime, the degree means an extra \$1.6 million. No other single factor explains economic well-being better than education—a resource available to all in America.

The lessons for countries are just as powerful. Nations with the most years of schooling and greatest amount of economic freedom tend to have the highest per capita incomes. The United

States is among them. Yet, international comparisons of educational achievement show U.S. students lag those in many other nations. So we must do better if we are to stay ahead of the Chinese and benefit from their success, rather than be victimized by it.

This brave new world of globalization will demand that we Americans re-examine how we do things ... and how we think. Some of the old rules may no longer apply for our businesses, workers, schools—and, yes, for the Federal Reserve as well. A globalizing economy—one increasingly open to the movement of goods, services, people and ideas—presents challenges to the conduct of monetary policy. In my opinion, the issues raised by globalization go beyond the present preoccupation with how many billions in U.S. Treasury securities the Chinese hold, or what weight the People's Bank of China assigns the dollar in the basket of currencies it now uses to value the renminbi.

Globalization calls into question the usefulness of some of our most familiar policy concepts and tools. Of what use, for example, are traditional measures of industrial capacity utilization, which compare firms' output to production limits, when any machine or assembly line can suddenly be made obsolete—economically irrelevant—by new technology or new competition from manufacturing operations overseas?

Globalization arguably reduces the relevance of the traditional Phillips curve analysis, which attempts to tie inflationary pressures to slack in the domestic labor market. It has long been recognized that swings in the prices of energy and other commodities can shift the Phillips curve relationship, as can changes in import prices. This substantially complicates policymaking. Globalization compounds the problems. Commodity prices become increasingly influenced by unpredictable swings in overseas economic activity. Import prices carry greater and greater weight, even though our understanding of how foreign corporations price their exports remains poor. This is definitely not a case where ignorance is bliss, for how monetary policy ought to respond to shocks will depend on what determines import prices.

More than ever, we must look beyond our borders to understand movements in inflation, interest rates and wages. There is evidence, for example, that long-term Treasury yields are sensitive to manufacturing trends in the large industrialized nations overseas. This raises questions about how we ought to measure the effectiveness of monetary policy. Which is the more reliable gauge in a world of integrated capital markets—the inflation-adjusted federal funds rate or the slope of the yield curve? Currently, they are sending very different signals.

Globalization raises so many other questions. Is there a greater or lesser role for monetary policy in a world where capital can cross national borders at the click of a mouse? Has the growth of world trade had a significant impact on inflation around the world? What are globalization's limits? How far down the path are we? And how much further can we expect to go?

One of my first acts as president of the Dallas Fed was to direct the Bank's research arm to explore how globalization is changing economic fundamentals and the making of monetary policy. We don't have all the answers. All we know is that an interconnected world with increasingly porous borders challenges long-held conventions about the gearing of the U.S. economy and the trade-offs between growth and inflation. We at the Dallas Fed intend to learn a

lot more about the impact of globalization, and we intend to share what we know, not just inside the Fed but outside it as well, with the goal of sharpening our collective peripheral vision.

Thank you.